Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20054

In the Matter of	)	
	)	
Elimination of Rate-of-Return Regulation of Incumbent Local Exchange Carriers	)	RM-10822
	)	
Federal-State Joint Board on Universal Service	)	CC Docket No. 96-45

Comments of the Ad Hoc Telecommunications Users Committee

Susan M. Gately
Helen E. Golding
Economics and Technology, Inc.
Suite 400
Two Center Plaza
Boston, MA 02108
617-227-0900

Economic Consultants

James S. Blaszak
Levine, Blaszak, Block & Boothby, LLP
2001 L Street, N.W., Suite 900
Washington, D.C. 20036
202-857-2550

Counsel for
The Ad Hoc Telecommunications
Users Committee

January 16, 2004

Table of Contents

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20054

In the Matter of	)	
	)	
Elimination of Rate-of-Return Regulation of Incumbent Local Exchange Carriers	))	RM-10822
	)	
Federal-State Joint Board on Universal Service	)	CC Docket No. 96-45

Comments of the Ad Hoc Telecommunications Users Committee

The Ad Hoc Telecommunications Users Committee (hereinafter "Ad Hoc") hereby submits comments on the Petition for Rulemaking to Eliminate Rate-Of-Return Regulation of Incumbent Local Exchange Carriers that Western Wireless Corporation filed on October 30, 2003.

Summary

Western Wireless' Petition for Rulemaking spotlights a problem that should concern the Commission and certainly concerns members of the Ad Hoc Telecommunications Users Committee, namely, large unexpected growth in the high cost support component of the Universal Service Fund (USF). The Commission has retained for too long the embedded cost standard for determining eligibility for and the size of USF high cost support payments to Rural Local Exchange Carriers (RLECs). The embedded cost standard, as modified by the *Rural Task Force Order,* provides an incentive for misallocation of costs and investment in plant not needed for services eligible for USF subsidies. At the very least, the embedded cost standard encourages

inefficiency.

The Commission certainly does not have the resources to rigorously audit RLEC accounts to ferret out improper accounting and cost allocations that may have led to growth in high cost support. Despite the Commission's reliance in the *RTF Order* on state certifications to prevent cost misallocations, it is at least unrealistic for the Commission to believe that State regulatory authorities and industry bodies have adequate resources or incentives to do the job that the Commission cannot do.

Moreover, Ad Hoc is unaware of any Commission efforts to determine if RLECs who receive high cost support maintain artificially low local service rates and/or enjoy "creamy" returns. Artificially low rates and "creamy" returns are not incompatible when an RLEC feeds on high cost support payments.

Although Ad Hoc does not know the extent to which each of several factors may have contributed to the large, unexpected growth in high cost support, it is reasonable to conclude that the embedded cost standard is the main problem. Ad Hoc understands that increased regulatory oversight is unlikely in the current environment. But such oversight is unavoidable if the Commission wishes to use the embedded cost standard in a responsible manner. Telecommunications service customers across the country deserve a thorough investigation of why the high the cost component of the USF has grown so rapidly, whether such growth will continue and what the Commission intends to do to rein-in such growth. An alternative that may obviate the need for such regulatory oversight would be for the Commission to initiate promptly a rulemaking that would propose to replace the embedded cost standard with a forward looking cost standard for purposes of determining eligibility for and sizing of high cost support. The

Commission should not wait until the end of the five-year term of the RTF Plan to start and conclude such a rulemaking. Part of that proceeding should include an effort to determine the cause(s) for the growth in the high cost component of the USF. If the Commission determines some RLECs have received high cost USF support for which they are not eligible under Commission Rules, the Commission should initiate show cause proceedings to reclaim any such amounts for the benefit of the USF and to impose fines on any such RLECs.

I. Background

There has been astonishing and unsustainable growth in the Universal Service Fund (USF) subsidies that have been distributed to rural local exchange carriers (RLECs) serving high cost areas since mid-2001. In May 1997 the Commission for the first time established mechanisms to provide explicit support for the universal service goals set forth in the Telecommunications Act of 1996 (1996 Act).[1] In the *Report and Order* and in subsequent orders in this docket, the Commission established the USF as the vehicle for explicit universal subsidies, defined the services eligible for USF subsidies, and set the cost benchmarks used to size USF high cost support for rural and non-rural carriers. Of particular interest for purposes of evaluating Western Wireless' petition is the RTF order.[2]

When the FCC adopted its new universal service funding mechanism pursuant to the Act, it made the decision to first implement the high-cost model based on forward-

---

[1] *Federal-State Joint Board on Universal Service,* 12 FCC Rcd 8776 (1997) (*Report and Order*) (subsequent history omitted).

[2] *Federal-State Joint Board on Universal Service,* Fourteenth Report and Order, 16 FCC Rcd 11244 (2001) (*RTF Order*).

looking costs for larger incumbent local exchange carriers (ILECs), permitting RLECs to remain under the older high-cost funding mechanism.[3] High-cost-related universal service support collected by large ILECs has remained virtually unchanged (at about $800,000,000) throughout 2001, 2002 and 2003.[4] As for the RLECs, the Commission accepted a Joint Board recommendation that RLECs receive high cost USF support based on a modified embedded cost standard, with additional "tweaks" to assure that the RLECs received adequate USF support, for a five year period.[5] RTF went into effect in July 2001. Since implementation of RTF, high cost support for RLECs has increased dramatically from about $1.73B for 2001, to nearly $2.75B for 2004 based upon the first quarter of 2004 a 58% increase in merely three years. In fact, since implementation of the RTF Order in mid-2001, high cost support for RLECs has grown by nearly a billion dollars.

In adopting RTF, the Commission estimated an an aggregate (cumulative) impact of $1.29-Billion over the five year term of RTF.[6] By then end of 2003, USF consumers the cumulative funds collected from the high cost portion of the USF fund collected for rural carriers was $1.5-Billion higher than it would have been absent the changes to the plan that have occurred starting with RTF. By the end of this year (using the 1st Q 2004 projected draw as a conservative indicator of what the full 2004 draw will be), close to $3.4-Billion in additional funds will have been collected from consumers. If growth in the fund continues at its present pace, by the end of 2005, the cumulative impact of growth in the fund will approach $5-Billion dollars – dwarfing the

---

3 *Report and Order* at 8934-37.

4 *See* Attachment A.

5 *RTF Order* at 11247-249.

Commission's $1.29-Billion RTF impact estimate.

Ad Hoc does not know how much of the growth in the high cost component of the USF is, as Western Wireless argues, attributable to rate-of-return regulation. It is, however, clear that high cost portion of USF cannot continue to grow as it has in the near-term past.

Ad Hoc does not know how much of the growth in the high cost component of the USF is, as Western Wireless argues, attributable to rate-of-return regulation. It is, however, clear that high cost portion of USF cannot continue to grow as it has.

II. Multiple Factors May Be Contributing To The Rapid Growth In High Cost Subsidies.

Ad Hoc *suspects* that a number of factors are responsible for the out-of-control growth in the high-cost support for RLECs. Those factors may include misallocation of investments and expenses by RLECs, as detailed in Western Wireless' Petition, inadequate regulatory review of RLEC cost allocations, flaws in the *RTF Order,* and a reluctance on the part of regulators to investigate RLECs' earnings and rates.

A. Cost Misallocations and Regulatory Oversight

Misallocation of costs by RLECs and a lack of accountability and auditing control with regard to the reported costs and investments made by RLECs appear to be major factors contributing to the greater than expected growth in high cost subsidies to RLECs. Past Commission Staff audits have found that ILECs' regulatory books of

---

6 *RTF Order* at fn 27**.

account reflect billions of dollars of unaccounted-for investments.[7] It would not be unreasonable to suspect that RLEC books of account also materially overstate relevant costs. Western Wireless notes that, "[n]o comprehensive audit of the regulatory accounts of the vast majority of rural ILECs has been conducted in the past decade, either by the FCC, state commissions, NECA, the Universal Service Administrative Co. ("USAC"), or independent auditors retained by the ILECs themselves."[8] Western Wireless also argues that the RLECs have opportunity and incentive to misallocate costs in a manner that would "[i]mproperly augment universal service disbursement and 'pad their rates.'"[9] Attachment A to Western Wireless' petition summarizes several state proceedings in which state regulatory authorities found the kind of troubling cost misallocation and overstatement about which Western Wireless is properly concerned. Thus, it appears that despite the fact that states are, "[t]o file annual certifications with

---

7 In February 1999, the Commission released the results of its audits of the Regional Bell Operating Companies' Continuing Property Records (CPRs) as these existed on June 30, 1997. The audits revealed overstatements in the RBOCs books estimated to be in the range of $5-Billion. *FCC Releases Audit Reports on RBOCs' Property Records*, Report No. CC 99-3, Common Carrier Action, February 25, 1999. See also *Audit of The Continuing Property Records of Ameritech Corporation, as of July 30, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("Ameritech CPR Audit"); *Audit of The Continuing Property Records of NYNEX Telephone Operating Companies also known as Bell Atlantic North, as of March 31, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("Bell Atlantic North CPR Audit"); *Audit of The Continuing Property Records of Bell Atlantic Telephone Operating Companies, also known as Bell Atlantic South, as of March 31, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("Bell Atlantic South CPR Audit"); *Audit of The Continuing Property Records of BellSouth Telecommunications, Inc., as of July 31, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("BellSouth CPR Audit"); *Audit of The Continuing Property Records of Pacific Bell and Nevada Bell Telephone Companies, as of June 30, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("Pacific Bell CPR Audit"); *Audit of The Continuing Property Records of Southwestern Bell Telephone Company as of June 30, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("SWBT CPR Audit"); *Audit of The Continuing Property Records of US West Telephone Operating Companies, as of June 30, 1997,* FCC Accounting Safeguards Division, December 22, 1998 ("US West CPR Audit"); Sections VI. Collectively, the seven RBOC CPR audits ("The RBOC CPR Audits").

8 Western Wireless Petition at 26, footnote omitted.

the Commission to ensure that carriers use universal service support ‘only for the provision, maintenance and upgrading of facilities and services for which the support is intended’ consistent with section 254(e),”[10] the certification requirement has not produced the level of regulatory oversight needed to prevent cost misallocations. So long as regulatory oversight of cost allocations and accounting is limited in scope and rigor and without significant “penalties” for misallocations and inaccurate accounting, RLECs have little incentive to incur costs efficiently and report them accurately. In light of the information set forth in Western Wireless’ petition and the growth in the high cost component of the USF, the Commission cannot confidently rely on state certifications with respect to RLECs. The states are unlikely to have the resources needed to do the investigations that would be necessary for the certifications to be reliable.

The Commission should not expect the states to have greater accounting and auditing resources than the Commission has; in fact, the states probably have fewer such resources than the Commission. The Commission has tasked the states with a job that neither they nor the Commission can do adequately. Ad Hoc is aware of the fact that states also provide certifications with respect to non-rural ILECS who receive USF high cost support money. But, as noted above, non-rural ILECs currently draw about the same level of USF high cost support as they drew in mid-2001. State certifications are unlikely to be the cause of the disparate patterns of demand for USF high cost support by non-rural ILECs on the one hand and RLECs on the other hand. Western Wireless may be right; the reason seems to lie in the different incentives inherent in a forward looking cost standard, versus an embedded cost standard, for high

---

9 *Id.*

cost eligibility and sizing.

Ad Hoc has suspected, but does not know, that some of the growth in the high cost component of the USF may be attributable to RLEC investments that are not needed to support the services that the USF is supposed to support, but instead, are parts of plans to upgrade RLEC networks so that they are broadband capable even though broadband services are not eligible to receive USF subsidies. Certainly, RLECs should not be precluded from modernizing their facilities used to provide basic service, to take advantage of more efficient technology (that lowers operating costs). They may not, however, build a broadband plant in so doing. Recently, Valor Telecommunications of Texas, L.P. requested a waiver of the cap on its high-cost loop support, largely for the purpose of making various network improvements. Valor's high-cost loop support, if the waiver were to be granted, would rise from approximately $71,000 per month[11] (or $850,000 annually) to approximately $850,000 per month (or $10.2 million annually). However, much of what Valor proposed to recover was not related to upgrades necessary for universal service, as the Commission has been defined universal service. In addition to costs to deploy CLASS services and voice messaging, Valor included in its waiver request costs for deployment of creating "a network that is capable of accommodating broadband" and the advanced services that would require such facilities. In this instance, Valor's effort to win a waiver motivated it to disclose the broad scope of its investment plans. There *could* be many other instances in which

---

10 *RTF Order* at 11317.

11 *Valor Petition* at Summary-1. At page 3, Valor indicates the $71,000 was the cap for support in the GTE-Contel service area that Valor acquired in September 2000; Valor also acquired exchanges from GTE in a second study area, for which GTE was not receiving any high cost loop support.

RLECs are improperly including such costs for recovery without the need for a waiver.

B. *RTF Order* Flaws

In commenting on the Rural Task Force proposal, Ad Hoc argued, *inter alia*, that the Commission should use a forward looking, rather than embedded, cost standard and that the Commission should not re-base the indexed cap on high cost line support and increase the corporate operations limitation.[12] The Commission chose to do otherwise. The Commission opted for a modified, embedded cost standard, re-based high-cost loop support and corporate operations expense and then provided growth factors for the re-based investment and expenses. For most significant issues the Commission erred on the side of encouraging RLEC network investment and inefficiency.[13]

When the Commission observed in the *Report and Order* that "[c]urrent support mechanisms neither ensure that ILECs are operating efficiently nor encourage them to do so,"[14] it was not speaking exclusively of price cap LECs. The Commission stated generally that, "[c]alculating high cost support based on embedded cost is contrary to sound economic policy."[15] As Western Wireless points out, the Commission has always recognized that the 1996 Act contemplates that the high-cost mechanism for universal service should be reformed for all carriers, not just the subset comprised of larger ILECs. However, in the *Report and Order*, *i.e.*, in 1997, the Commission opted to delay

---

12 Ad Hoc Telecommunications Users Committee, Reply Comments at 13-14, November 30, 2000, CC Docket No. 96-45.

13 *RTF Order* at 11249-11251 for a summary of the Commission actions that have encouraged RLEC inefficiency and perhaps cost misallocations.

14 Universal Service First Report and Order, 12 FCC Rcd at 8924-35, para. 292.

15 *Report and Order* at 8935.

for three years use of forward-looking costs for calculating high cost support for RLECs, but still contemplated a "gradual" shift to forward-looking economic costs.[16] In the *RTF Order* adopted four years later, the Commission decided to continue to use an embedded cost standard, albeit with modifications, for five more years, *i.e.*, for six years longer than indicated in the *Report and Order*. The Commission, however, went on to state that it anticipates, "[c]onducting a comprehensive review of the high-cost support mechanism for rural and non-rural carriers as a whole to ensure that both mechanisms function efficiently and in a coordinated fashion."[17] The Commission declared that in comprehensive review it would consider, "[g]eneral issues related to excessive fund growth and competitive entry."[18] The Commission should move forward with such a comprehensive review with a sense of urgency despite the fact that the *RTF Order* anticipated a five year term for the RTF Plan. The time has come for the Commission to establish a firm deadline for making whatever input modifications are necessary to bring RLECs under a forward-looking cost model for high cost USF support. Growth in the high cost component of the USF cannot continue unabated.

The Commission should also re-think the need for the Safety Net Additive[19] and the Mergers and Acquisitions Cap and Safety Valve Mechanism.[20] Both measures were added to the RTF Plan to support RLEC infrastructure investment. Given the explosive growth in the high cost component of the USF, it is not clear how much more encouragement RLECs need to invest to infrastructure and whether the infrastructure

---

16 *Id.* at 8935-36.
17 *RTF Order* at 11310.
18 *Id.*
19 *Id.* at 11276-11281.

investment is only to support services that fall within the definition of universal service. If RLECs have used these mechanisms to any material degree, the Commission should consider the extent to which problems inherent in modified embedded cost standard may also be reflected in subsidies provided pursuant to these "safety" mechanisms.

C. High Cost Support Should Not Exceed What Is Necessary To Sustain Universal Service.

As it reviews in detail in a recent Order in CC Docket 96-45,[21] since the passage of the 1996 Act, the Commission has "[a]dopted significant universal service and access charge reforms, *in particular for the larger, price cap carriers*."[22] In many of these reforms, the objective has been to move away from implicit and toward explicit federal universal service support mechanisms. Summing up the progress made since 1996 in this regard, the Commission states:

> In concert with other reforms to the interstate access rate structure adopted in the *CALLS* and *MAG Orders*, the IAS and ICLS mechanisms have reduced the recovery of interstate common line costs through inefficient rate elements containing implicit support and facilitated the transition toward fuller, more rational competition, while ensuring that rates and services in rural and high-cost areas remain affordable and reasonably comparable to those in urban areas.[23]

While the Commission has made considerable headway in this regard, it has been less vigilant in scrutinizing the underlying level of support (originally implicit, now increasingly explicit) that is necessary for universal service. Merely converting implicit support levels

---

20 *Id*. at 11281-11292.

21 *Federal-State Joint Board on Universal Service*, CC Docket 96-45, Order on Remand, Further Notice of Proposed Rulemaking, and Memorandum Opinion and Order, FCC 03-249, released October 27, 2003 (*October 2003 Remand Order*).

22 *October 2003 Remand Order* at paras. 99-107.

23 *October 2003 Remand Order* at para. 105.

to explicit support is not enough to ensure that high cost support is limited to what is necessary to ensure universal service. In addition to moving to a forward-looking cost basis for high cost support, and thus eliminating the need for the *RTF Order* tweaks and the need for rigorous regulatory oversight of RLEC cost allocations and accounting, the Commission should consider the level of high cost support necessary for the preservation of universal service and to assure that RLEC rates are comparable to urban rates. Western Wireless states that RLECs "[t]ypically recover 50% to 75% of their revenues from universal service funding and access charges, not from their own customers; and a significant number of those carriers maintain unreasonably low retail rates."[24] As long as RLECs maintain unreasonably low retail rates, particularly for residential customers, regulatory authorities have no incentive to investigate RLEC rates of return. To what extent are high cost payments being used to support high rates of return for RLECs and/or artificially low local service rates? Ad Hoc does not know, but submits that the Commission should not ignore the possibility that RLECs are earning "creamy" returns and that some RLEC local service rates are too low. Given that very substantial federal high cost support flows to RLECs, the Commission has a responsibility to ratepayers across the nation to assure that high cost subsidies are not enriching the RLECs or being used to keep RLEC local rates too low.

[24] Western Wireless Petition at 40.

III. Conclusion

It has been nearly eight years since Congress mandated that universal service support be reformed in a manner that is targeted and pro-competitive. Even prior to the 1996 Act, the Commission had identified serious defects in the existing high-cost funding mechanism. The growth in the absolute support level and the portion of high-cost support that goes to RLECs is disproportionate to any growth in lines or reasonable investment strategies. The impact of the archaic high-cost mechanism for RLECs is not benign; rather it places an unacceptable financial burden on consumers nationwide. Ad Hoc has not objected to, and is not objecting to, providing the USF support that is necessary to preserve universal service in high cost areas and to assure reasonable rate comparability, and that at same time is economically efficient and pro-competitive. The current high cost support mechanism applicable to RLECs is, however, a very costly failure when measured against those standards. The time has come for the Commission to open a comprehensive proceeding to reform interstate high-cost funding for RLECs.

Respectfully submitted,

James S. Blaszak
Levine, Blaszak, Block and Boothby, LLP
2001 L Street, NW
Suite 900
Washington, DC 20036
202-857-2550

Counsel for
The Ad Hoc Telecommunications
Users Committee

January 16, 2004

Attachment A

Table 1

Growth of the Rural and Non-Rural
Portions of the High Cost Fund

Quarter	Total Annualized Non-Rural High Cost Support		Total Annualized Rural High Cost Support
2004 (1)	$ 813,712,676		$ 2,742,476,506
2003	$ 825,030,839		$ 2,515,145,688
2002	$ 811,220,166		$ 1,967,122,344
2001	$ 792,416,409		$ 1,729,443,772
% increase from 2001-2004	**2.7%**		**58.6%**

Source: Universal Service Administrative Company, Quarterly Administrative Filings to the FCC, 2001-2004.
(1) Annualized result based upon first Q of 2004.